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INFO RUEHBK/AMEMBASSY BANGKOK 0228
RUEHBJ/AMEMBASSY BEIJING 3078
RUEHRL/AMEMBASSY BERLIN 0020
RUEHBS/USEU BRUSSELS 0030
RUEHBY/USDAO CANBERRA ACT AS
RUEHCN/AMCONSUL CHENGDU 2212
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUEHGV/USMISSION GENEVA 0070
RUEHGZ/AMCONSUL GUANGZHOU 0670
RUEHHI/AMEMBASSY HANOI 0042
RUEHHK/AMCONSUL HONG KONG 2377
RUEHJA/AMEMBASSY JAKARTA 0036
RUEHLO/AMEMBASSY LONDON 8778
RUEHML/AMEMBASSY MANILA 0105
RUEHMO/AMEMBASSY MOSCOW 0079
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC
RUEHNE/AMEMBASSY NEW DELHI 0069
RUEHOT/AMEMBASSY OTTAWA 0043
RUEHFR/AMEMBASSY PARIS 0017
RUEHRO/AMEMBASSY ROME 0018
RUEHUL/AMEMBASSY SEOUL 0562
RUEHGH/AMCONSUL SHANGHAI 8942
RUEHSH/AMCONSUL SHENYANG 2203
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RUEHKO/AMEMBASSY TOKYO 0773

UNCLAS SECTION 01 OF 04 SHANGHAI 000401

SENSITIVE
SIPDIS

DEPT FOR EAP/CM
NSC FOR LOI, MEDEIROS
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN
GENEVA ALSO FOR USTR
USDOC FOR ITA DAS KASOFF, MELCHER, SZYMANSKI, MAC/OCEA
TREASURY FOR OASIA/INA -- DOHNER/HAARSAGER/WINSHIP
TREASURY FOR IMFP -- SOBEL/CUSHMAN
STATE PASS CEA FOR BLOCK
STATE PASS CFTC FOR OIA/GORLICK
MANILA FOR ADB USED

E.O. 12958: N/A
TAGS: CH ECON EFIN EINV PGOV
SUBJECT: CHINESE BANKS DEMANDING ASSURANCES ON FOREIGN BANKS'
DERIVATIVE TRANSACTIONS

¶1. (SBU) Summary: New Chinese regulations governing derivatives trading that went into effect September 16 are having a disproportionate negative impact on foreign-invested firms. In the face of efforts by foreign-invested banks to modify or roll back the requirements, the major Chinese banks are acting in unison to largely refuse compromise. As a result, foreign-invested bank market share and profits are at risk. End Summary.

Background

¶2. (SBU) One year after the Lehman bankruptcy, China's Central Government and domestic banks are beginning to implement measures to reduce counterparty risk in financial transactions. Beginning September 16, the largest Chinese domestic banks, with the support of the People's Bank of China (PBOC) -- are requiring their foreign-invested counterparts to obtain credit guarantees from their parent companies before engaging in over-the-counter foreign exchange derivatives transactions. The banks' demand is part of a new master agreement structure announced on March 16, 2009, by the National Association of

Financial Market Institutional Investors (NAFMII) -- nominally an industry self-regulatory body spun off from the PBOC -- and formally endorsed by the PBOC in a notice dated March 11, 2009. Under the measures, counterparty banks had six months to sign agreements, and the major domestic banks have elected to make the parent guarantee a precondition.

¶3. (SBU) EconOff spoke about the impact of the new regulations with several senior executives in Shanghai-based foreign-invested banks that are prominent players in the Chinese over-the-counter derivatives market, as well as with an academic contact. Foreign-invested banks with operations in Shanghai include Citibank, HSBC, Standard Chartered, JPMorgan, and Deutsche Bank. The Big Five Chinese domestic banks are Industrial and Commercial Bank of China (ICBC), China Construction Bank, Bank of China, Agricultural Bank of China, and Bank of Communications; in addition, China Development Bank was mentioned by contacts as among the major domestic players in derivatives trades.

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New Guarantees Seen As Discriminatory
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¶4. (SBU) Most foreign-invested banks view as discriminatory the demands by their domestic counterparts to obtain parent-bank guarantees for over-the-counter derivatives trades. Starting in 2006, said several contacts, the China Banking Regulatory Commission and other Chinese regulators put pressure on foreign-invested banks to incorporate locally. This placed a substantial compliance burden on the foreign-invested banks,

including: a lengthy application process; continued monitoring that the locally incorporated subsidiary has decision making authority independent of its parent bank; and minimum paid-in capital of RMB one billion (approximately US$150 million). Now, the largest domestic Chinese banks are, in effect, seeking to renege on the benefits foreign-invested banks were supposed to enjoy as a result of local incorporation, said the contacts -- creating the perception of arbitrary rulemaking. In addition, Chinese domestic banks are not requiring their domestic bank counterparties to offer additional guarantees for derivatives trades. One contact also noted that this requirement has not been imposed on foreign subsidiary banks in any other market around the world, and another said that multinational bank holding companies are not structured to provide guarantees to their overseas subsidiaries.

¶5. (SBU) Major domestic banks are currently acting in unison with respect to the parent-bank guarantees. One contact mentioned that Bank of China is the strongest proponent of the requirement. (Note: Bank of China is historically the most exposed among the Chinese domestic banks to overseas transactions, as it has the largest overseas branch network and dominates the market for foreign-invested enterprise services. End note.) At one point, ICBC was not requiring a parent guarantee in its revised master agreements, and contacts stated that Citi and Deutsche Bank had signed with ICBC without giving one. However, the other large banks then put pressure on ICBC and it fell into line.

¶6. (SBU) NAFMII is not seen by foreign-invested banks as completely neutral in the process of rolling out the new master agreements. One bank executive said that NAFMII tends to represent the interests of domestic banks, since Citi and HSBC are the only foreign banks represented on the board. (Comment: This limits the role that NAFMII might play in brokering a compromise between the major Chinese banks and the foreign-invested banks. End comment.)

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Compromise Has Been Struck In Limited Cases
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¶7. (SBU) Some locally incorporated foreign-invested banks have been able to sign master agreements with smaller banks, providing some cause for hope that major Chinese banks may also eventually do so. One contact put the number at around twenty for all foreign-invested banks, about half with other foreign-invested banks and the other half with local Chinese banks. For example, one executive said his bank had signed master agreements without the parent guarantee with several local medium-size banks.

¶8. (SBU) Other banks are seeking to modify the major Chinese

banks' parent guarantee requirement. For example, one contact said that foreign-invested wholesale banks such as JPMorgan had trouble meeting the paid-in capital standard when applying for local incorporation, and in the end had used a form of parent guarantee. These banks are working with local counterparties to see if this will cover the new requirement. An executive in one bank in these circumstances said that an agreement under these conditions had been negotiated with ICBC, but that ICBC had not signed it before the September 16 deadline because the relevant bank official was said to be "on travel."

¶9. (SBU) One bank executive suggested that the problem between the foreign-invested banks and the major domestic banks could resolve itself with time. It has been a relatively short time to negotiate this complicated issue, he said, and it is possible that more agreements will be announced shortly.

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Market Volume Has Dropped
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¶10. (SBU) The volume in the derivatives market was down significantly in the days following the September 16 deadline. According to the head of trading at a major derivatives trading firm among foreign-invested banks speaking on September 21, volume has been consistently half the normal level. Others pointed out that the lower volume could be due, in part, to other factors as well. For instance, interest rates have been relatively stable recently, meaning that firms have less reason to purchase derivatives to arbitrage or hedge against changes.

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Foreign-Invested Bank Profits at Risk
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¶11. (SBU) Over the next few weeks, the lack of master agreements with Chinese domestic banks will start to cut into the profits of foreign-invested banks. Banks that have not signed are prohibited by the PBOC from trading in derivatives markets, according to the March 11 PBOC notice. Currently, foreign-invested banks have a strong market share, with approximately one-third of the volume of foreign-exchange swaps -- the larger and more liquid derivatives market in China -- and approximately half of the volume of interest rate swaps. (Comment: Derivatives trading is an area of competitive strength for foreign-invested banks, which by comparison only account for a little over 2 percent of total banking system assets in China. End comment.)

¶12. (SBU) Even if master agreements are signed, domestic banks may be able to take advantage of the parent guarantee requirement to gain market share from foreign-invested banks. One bank executive said that adding the parent guarantee would force them to widen the bid-offer spread, due to additional

transaction costs. This would make foreign-invested banks less competitive vis-a-vis their domestic counterparts. Since Chinese banks have a bigger customer base, they will be able to leverage this cost differential over time to sway customers towards their services.

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Comment
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¶13. (SBU) The Chinese financial system's view of foreign-invested banks is shifting in the wake of the global financial turmoil that broke out in the fall of 2008. Both Chinese domestic banks and Chinese regulators are taking a more cautious approach to financial derivatives and other foreign-developed products that they blame for instigating that crisis. While the fears raised by the crisis may take time to work out -- and the Chinese authorities are looking in part to regulatory changes that their counterparts in the United States and other developed markets put in place -- there also appears to be room for the Chinese side to compromise on the demands for parent guarantees of over-the-counter derivatives transactions. The PBOC, for example, could extend the September 16 deadline for banks to negotiate amongst themselves while not disrupting the market, and perhaps also indicate to Chinese domestic banks that legitimate risk concerns can be accommodated without parent guarantees. However, our Shanghai contacts did not offer specifics on how internal PBOC dynamics must be realigned in order to modify implementation of the new master agreement structure.
CAMP